

THE INTRASTATE EXEMPTION: CURRENT LAW, LOCAL PRACTICE AND THE WHEAT REPORT

In September, 1969, the Securities and Exchange Commission (SEC) announced new proposed rules governing the public resale, without registration, of limited quantities of certain investment securities which were originally acquired in a private placement or held by a control person.¹ In general, these rules provide that a relatively insubstantial amount² of a "qualified" issuer's "restricted securities," i.e., those acquired in a private offering from a reporting company,³ may be sold in ordinary trading transactions, after having been held by the offeror for a period of at least one year.⁴ The proposed rules also apply to similar dispositions made on behalf of a person controlling the issuer.⁵ Perhaps the most significant and innovative change in securities regulation since the enactment in 1933 of the Securities Act itself, these rules represent the first move on the part of the Commission to implement some of the major policy recommendations contained in the "*Wheat Report*."⁶ They also indicate the extent to which the SEC has accepted some of the principles underlying those recommendations.

This being so, it would appear worthwhile to consider the possible effects which those policy changes may portend in a closely-related area of securities law—that pertaining to intrastate offerings. Such is the purpose of this article. After reviewing the current state of the law on this subject and after noting local practices which have been adopted to comply therewith, an attempt will be made to assess the potential impact of the *Wheat Report* proposals on the use of the intrastate exemption.

I. RULES REGULATING THE USE OF 3(a)(11)

Section 3(a)(11) of the Securities Act of 1933 specifically exempts from the registration and prospectus requirements of section 5:

Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such

¹ SEC Securities Act Release No. 4997 (Sept. 15, 1969).

² For an explanation of the meaning of this phrase, see text and sources accompanying note 136, *infra*.

³ For an explanation of the meaning of these terms, see text and sources accompanying notes 126-29, *infra*.

⁴ SEC Securities Act Release No. 4997 (Sept. 15, 1969).

⁵ *Id.* It should be noted that, since the proposed rules also apply to persons controlling, or controlled by, the issuer, SEC Rule 154, 17 C.F.R. § 230.154 (1970) will no longer be necessary; consequently, it will be rescinded. See also, text and sources accompanying notes 125, 137-8, *infra*.

⁶ SEC STAFF, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS—THE WHEAT REPORT 18-27, 149-247 (CCH ed., 1969). [Since this report was prepared under the direction of Commissioner F. M. Wheat, it is known and will hereinafter be cited as the *Wheat Report*.]

security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.⁷

The purpose of this exemption was not so much to immunize federal securities law from any constitutional infirmity thought to exist with respect to wholly intrastate offerings; rather its aim was to preserve state control over the raising of capital by business concerns whose activities were largely confined to a single state.⁸ It is this policy which has so markedly affected the development of 3(a)(11). In the words of the Commission, "[t]he legislative history . . . clearly shows that this exemption was designed to apply only to local financing that may practicably be consummated in its entirety within the State or Territory in which the issuer is both incorporated and doing business."⁹ Hence most of the rules concerning intrastate offerings have focused on keeping a given distribution within the territorial boundaries of a single state. It is to these rules that the following discussion is directed.

A. The "Issue" Concept: The Requirement of Ultimate Distribution to Resident Investors

Many of the important restrictions on the availability and use of 3(a)(11) stem from ideas associated with the statutory term "issue." As interpreted, this term has come to mean that the "entire issue" of similar classes of investment securities must be offered and sold exclusively to residents who have purchased for investment and not with the intention of reselling outside the state in question.¹⁰ From this statement of the rule, it should be evident that the issue concept in 3(a)(11) cannot be avoided or evaded merely by floating "a part of the issue," i.e., substantially the same securities, in different states.¹¹ Thus where an issuer makes

⁷ Securities Act of 1933, § 3(a)(11), 15 U.S.C.A. § 77c(a)(11)(1963) [hereinafter cited as "Securities Act" and occasionally referred to as the "Act" or the "'33 Act'"].

⁸ See text and sources accompanying notes 156-64, *infra*.

⁹ SEC Securities Act Release No. 4434 (Dec. 6, 1961), 17 C.F.R. § 231.4434 (1970) [hereinafter cited as Sec. Act Release 4434 (1961)]. This release which was ". . . published to provide in convenient and up-to-date form a restatement of the principles underlying Section 3(a)(11) as so expressed over the years . . ." is probably the most comprehensive and authoritative source in this area of federal securities law. See also, Op. Gen. Counsel, Securities Act Release No. 1459 (May 29, 1937), 17 C.F.R. § 231.1459 (1970) [hereinafter cited as Sec. Act Release 1459 (1937)] and SEC Securities Act Release 4386 (July 12, 1961) [hereinafter cited as Sec. Act Release 4386 (1961)] both of which express the identical thought in practically the same language. Since most of the ideas outlined in Sec. Act Release 4434 (1961) were originally articulated in the latter two releases, reference to all three will be frequent.

¹⁰ Sec. Act Release 4434 (1961); Sec. Act Release 4386 (1961); Sec. Act Release 1459 (1937). Generally, see authorities cited notes 11-33, *infra*; McCauley, *Intrastate Securities Transactions under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959); Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 W. RES. L. REV. 110 (1964).

¹¹ Sec. Act Release 4434 (1961); Jackson Tool & Die, Inc. v. Smith, 339 F.2d 88, 90 (5th Cir. 1964), *reviewed after trial*, 419 F.2d 152 (5th Cir. 1969); Peoples Securities Co., 39 S.E.C. 641, 650-52 (1960), *aff'd sub nom. without consideration of this point*, Peoples

nearly contemporaneous offerings in several states of two or more "classes" of securities—or "issues"—the terms of which are practically identical, such securities might be viewed as an "integrated" part of a "single plan of financing"; if so, the offerings would be treated as a single *interstate* offering of the same "issue."¹² Should this occur, the "intrastate" aspect of the offering, having been made without a registration statement in effect, would contravene the provisions of section 5. And this result would obtain even though the alleged offerings in other states were registered or were purportedly made pursuant to different exemptions.¹³ It should further be evident, and it has been so held on a number of occasions, that the requirement of offer and sale "only to persons resident" is by no means limited to initial transfers between the issuer and those in the distributive chain;¹⁴ in fact, the residency of principal underwriters and selling dealers is irrelevant.¹⁵ Likewise, the exemption is not necessarily available simply because dealers confine their initial sales to persons resident within the state. For, should the latter prove to be mere conduits for non-resident purchasers, an *interstate* distribution would have taken place.¹⁶ What is required by the "issue" concept then is that "*at the time of completion of ultimate distribution, [all such securities offered and sold] shall be found only in the hands of investors resident within the state.*"¹⁷

Hence any "casual" resale to a non-resident by an ordinary, non-

Securities Co. v. SEC, 289 F.2d 268 (5th Cir. 1961); Texas Glass Mfg. Corp., 38 S.E.C. 630, 634-35 (1958); Shaw v. United States, 131 F.2d 476, 480 (9th Cir. 1942); 1 L. Loss, SECURITIES REGULATION 593, 577-78 (2d ed. 1961) [hereinafter cited as 1 Loss]. Cf., Unity Gold Corp., 3 S.E.C. 618, 625-26 (1938). See also, SEC v. Hillsborough Investment Corp., 176 F. Supp. 789 (D.N.H. 1959), *preliminary injunction*, 173 F. Supp. 86 (1958), *aff'd*, 276 F.2d 665 (1st Cir. 1960); SEC v. Los Angeles Trust Deed & Mortgage Exchange, 186 F. Supp. 830, 870-72 (S.D. Cal. 1960), *aff'd*, 285 F.2d 162, 172 (9th Cir. 1960), *cert. denied* 366 U.S. 919 (1961). Cf., SEC v. Dunfee, CCH FED. SEC. L. REP. § 91,970 (W.D. Mo. 1966-67).

¹² Authorities cited note 11, *supra*. See, SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H. R. DOC. NO. 95, 88th Cong., 1st Sess., Part 1, 572, n.222 (1963) [hereinafter cited as 1963 *Special Study*.]

¹³ Authorities cited note 11, *supra*; FTC Securities Act Release No. 97, part 10 (Dec. 28, 1933) 17 C.F.R. § 231.97(j)(1970); 1 Loss at 593.

¹⁴ Sec. Act Release 4434 (1961); Sec. Act Release 4386 (1961); Sec. Act Release 1459 (1937); FTC Securities Act Release No. 201 (July 20, 1934), C.F.R. § 231.201 (1970) [hereinafter cited as Sec. Act Release 201 (1934)]. Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 158-62 (1935). See, Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269, 274-5 (10th Cir. 1957). See also, cases cited notes 21 & 23, *infra*.

¹⁵ Sec. Act Release 4434 (1961).

¹⁶ Obviously, the use of resident nominees, agents, and the like to circumvent the requirement would be illegal, see, e.g., FTC Securities Act Release No. 97, part 9 (Dec. 28, 1933), 17 C.F.R. § 231.97(i)(1970); Armstrong, Jones & Co., SEC Securities Exchange Act Release 8420 (Oct. 3, 1968), *aff'd sub nom.*, Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 361 (6th Cir. 1970); Belhumeur v. Dawson, 229 F. Supp. 78, 85 (D. Mont. 1964); SEC v. Hillsborough Investment Corp., 173 F. Supp. 86, 87-90 (D.N.H. 1958), *permanent injunction*, 176 F. Supp. 789 (1959), *aff'd*, 276 F.2d 665 (1st Cir. 1960); 1 Loss at 596, n.133, & 604. See also, authorities cited notes 21 & 23, *infra*.

¹⁷ Sec. Act Release 201 (1934); Sec. Act Release 1459 (1937). [Emphasis in original in the latter release.]

professional, resident investor, soon after he first acquired the securities, could result in the Commission's determination that he had purchased with a view to, or had sold for the issuer in connection with, the distribution, or that he had indirectly participated in the underwriting of the issue.¹⁸ Accordingly, the resident seller would be deemed a statutory "underwriter" under section 2(11), for whom no exemption would be available.¹⁹ If, on the other hand, the Commission decided that the securities so acquired were "held for investment" only and not for the purpose of engaging in the distribution, then any such casual resale would not be improper or violative of the Act.²⁰ Far more important, however, from the point of view of those actually participating in the underwriting are the disastrous consequences that his action could have on their undertaking. For an adverse determination would not only put him in violation of the Act; it would also destroy the exemption for the entire issue.²¹ As to this, the SEC has remained adamant: "[i]f any part of the issue is offered or sold to a non-resident, the exemption is unavailable not only for the se-

¹⁸ Securities Act § 2(11), 15 U.S.C.A. § 77b(11)(1963), provides in part: "The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or . . . in the direct or indirect underwriting of any such undertaking. . . ."

¹⁹ *Id.*; Securities Act § 4(1), 15 U.S.C.A. § 77d(1)(Supp. 1970); Sec. Act Release 4434 (1961); Sec. Act Release 4386 (1961); Sec. Act Release 1459 (1937); SEC v. Van Horn, 371 F.2d 181, 188-89 (7th Cir. 1966). See, text and sources accompanying notes 16, 23-24, & 27-33. Cf., *Wheat Report* at 160-72, 203-05.

²⁰ Sec. Act Release 4434 (1961); Sec. Act Release 1459 (1937).

²¹ Sec. Act Release 4434 (1961); Sec. Act Release 4386 (1961); Sec. Act Release 1459 (1937); *Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420* (Oct. 3, 1968), *aff'd sub nom., Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 361 (6th Cir. 1970); *Jackson Tool & Die, Inc. v. Smith*, 339 F.2d 88, 90 (5th Cir. 1964), *reviewed after trial on a different point*, 419 F.2d 152 (5th Cir. 1969); SEC v. Van Horn, 371 F.2d 181, 188-89 (7th Cir. 1966); *Capital Funds, Inc. v. SEC*, 348 F.2d 582, 584-87 (8th Cir. 1965); *Belhumeur v. Dawson*, 229 F. Supp. 78, 85 (D. Mont. 1964); SEC v. Hillsborough Investment Corp., 173 F. Supp. 86, 87-90 (D.N.H. 1958), *permanent injunction*, 176 F. Supp. 789 (1959), *aff'd*, 276 F.2d 665 (1st Cir. 1960); *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 274-75 (10th Cir. 1957); *Associated Investors Securities, Inc.*, 41 S.E.C. 160, 163 (1962); *Universal Service Corp.*, 37 S.E.C. 559, 563-64 (1957); *Professional Investors, Inc.*, 37 S.E.C. 173, 175 (1956); *Petersen Engine Co.*, 2 S.E.C. 893, 903 (1937); cases cited note 23, *infra*. It should be noted here that:

The intrastate exemption is not dependent upon non-use of the mails or instruments of interstate commerce in the distribution. Securities [issued under 3(a)(11)] . . . may be offered and sold without registration through the mails or by use of any instruments . . . in interstate commerce. . . . It should be emphasized, however, that the civil liability and antifraud provisions of Sections 12(2) and 17 of the Act nevertheless apply and may give rise to civil liabilities and to other sanctions. . . . Sec. Act Release 4434 (1961).

On the other hand, a "face-to-face" sale to a non-resident would still destroy the exemption, even though there was no use of the mails or interstate commerce, and even though that particular sale would not be violative of § 5. "That is to say, a sale (whether to a resident or a non-resident) cannot itself violate § 5 if no use is made of the jurisdictional means in any step of the transaction; but even a face-to-face sale to a non-resident makes illegal those sales (whether to residents or non-residents) which do involve some use of the mails or interstate facilities." 1 LOSS at 593. This would be so because the offering would then have become an interstate distribution. See, H.R. REP. NO. 1838, 73d Cong., 2d Sess. 40 (1934).

curities so sold, but for all securities forming a part of the issue, including those sold to residents."²²

This particular view of the law raises some difficult questions for counsel and especially for those involved in the chain of distribution. Under the present rule as formulated, even a solitary, inadvertent and otherwise innocuous *offer* to a non-resident could conceivably invalidate the exemption and, with it, the entire underwriting effort.²³ This would be so, even though no actual sales to non-residents were made. Concededly this is improbable. Most counsel believe that cases such as these are never prosecuted. Usually, they say, a hint of fraud must be present merely to warrant the expense of investigation. Nevertheless, the authorities have often stated that a single improper *sale* is sufficient to destroy the exemption.²⁴ Moreover, a "pattern" of several such sales could supply that hint of fraud. And any substantial "trading" activity emerging soon after the initial offering could certainly make the entire issue suspect.²⁵ Even a public advertisement which failed to appropriately limit its solicitation to resident investors could cast doubt upon the "local" character of the offering.²⁶ For these reasons, rigorous policing of the entire distributive process is mandatory if an issuer is to comfortably rely on 3(a)(11).

A related and equally troublesome problem under the current rule is the test which is employed to determine the effect of an out-of-state sale upon the validity of the exemption. Perhaps the best characterization of this standard is the one made by the Commission itself:

The relevance of any such resales consists only of the evidentiary light

²² Sec. Act Release 4434 (1961); Sec. Act Release 4386 (1961). See, Sec. Act Release 1459 (1937).

²³ Hillsborough Investment Corp., 173 F. Supp. 86, 87-90 (D.N.H. 1958), *permanent injunction*, 176 F. Supp. 789 (1959), *aff'd*, 276 F.2d 665 (1st Cir. 1960); Edsco Mfg. Co., 40 S.E.C. 865, 869 (1961); 1963 *Special Study* at 571, n.220 and accompanying text; 1 LOSS at 592. See, S. REP. NO. 1036 at 13, H.R. REP. NO. 1542 at 22, 83rd Cong., 2d Sess. (1954); Whitehall Corp., 38 S.E.C. 259, 268-70 (1958). Cf., SEC v. Dunfee, CCH FED. SEC. L. REP. ¶ 91,970 (W.D. Mo. 1966-67); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

²⁴ See authorities cited note 23, *supra*.

²⁵ In Sec. Act Release 4386 (1961), the Commission described the situation referred to in the text as follows:

... [T]he quick commencement of trading and prompt resale of portions of the issue to non-residents raises a serious question whether all of the issue has, in fact, come to rest in the hands of investors resident in the state of initial offering. Where these practices are followed, it is *likely* that portions of the issue will be offered or sold to non-residents through residents and dealers purchasing for resale and thus constitute elements of the distribution to investors. [Emphasis added].

Thus any substantial "trading" activities which developed soon after the initial offering could result in an SEC investigation to determine whether improper resales had in fact been made. Cf., *Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420* (Oct. 3, 1968), *aff'd sub nom.*, *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 361 (6th Cir. 1970); Sec. Act Release 4434 (1961); Sec. Act Release 201 (1934); *Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147 (1935).

²⁶ Sec. Act Release 4434 (1961); Sec. Act Release 1459 (1937); see, *SEC v. Dunfee*, CCH FED. SEC. L. REP. ¶ 91,970 (W.D. Mo. 1966-67).

which they might cast upon the factual question whether the securities had in fact come to rest in the hands of resident investors. If the securities are resold but a short time after their acquisition to a non-resident this fact, although not conclusive, might support an inference that the original offering had not come to rest in the state, and that resale therefore constituted a part of the process of primary distribution; a stronger inference would arise if the purchaser involved were a security dealer.²⁷

The standard then is "whether the securities had in fact come to rest in the hands of resident investors";²⁸ that is, whether or not the seller had purchased his securities with the "view to further distribution" or with the intention of later reselling them outside the state.²⁹ In short, the test is a subjective one, dependent by and large upon an *ex post facto* inquiry into that elusive realm known as the seller's state of mind.³⁰ Partially on the basis of his status and possibly his connection with the issuer (i.e., was the seller a dealer, an affiliate, a lone speculator, a benign widow, etc.) but primarily on the basis of the length of time that he held the securities,³¹ a selection is made as to which of his several, varying "motives" for acquiring the securities was the "principal" one. The holding period is crucial to this retrospective determination: a resale to a non-resident effected within a year after purchase would most likely be fatal,³²

²⁷ Sec. Act Release 4434 (1961); Sec. Act Release 1459 (1937) (nearly identical language); see, notes 16 & 19 *supra*, and accompanying text.

²⁸ Sec. Act Release 4434 (1961) (quote in text at note 27, *supra*).

²⁹ Authorities cited notes 19 & 27, *supra*.

³⁰ Authorities cited notes 19, 27 & 31. Cf., SEC Securities Act Release No. 4552 (Nov. 6, 1962), 17 C.F.R. § 231.4552 (1970) [hereinafter cited as Sec. Act Release 4552 (1962)]; *Wheat Report* at 160-72 and authorities cited.

³¹ See authorities cited notes 19, 27 & 30, *supra*. Mulford, *Private Placements and Intra-state Offerings of Securities*, 13 BUS. LAW. 297 (1958) briefly describes the inquiry into seller's intention as follows:

To obviate improper claims of exemption in such cases, [i.e., resales of 4(2) or 3(a)(11) securities] the Commission feels that issuers and underwriters should require, at least in all cases where they do not know the facts themselves, detailed statements of the financial condition of the purchaser and his intentions, showing that the purchaser, for example, did not borrow money to buy the securities so that he will not likely have the intention or be forced to sell them in the near future to pay his debts. In other words, the Commission must be shown, if a case is questioned, that a purchase was not a purchase for deferred sale. Thus a purchase where the purchaser intends to sell within 6 months, after the capital gains income tax period has elapsed, or even a year, will not be regarded by the Commission as a purchase for investment. The Commission will require some evidence of changed circumstances in the purchaser's personal life or business, not foreseen when he bought the security, before it will believe that he did in fact purchase it for investment, if he actually sold it soon after its purchase. If, for example, a few months after his purchase, the investor decides to go into a new business which needs capital, or his house burns down, or he has a serious, expensive illness in the family, probably the Commission would agree that his sale of the security in order to raise funds to meet one of these emergencies was not evidence that he intended to resell the security when he purchased it. *Id.* at 299.

Cf. also, e.g., Crowell-Collier Pub. Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959).

³² A one-year period was suggested in the *Brooklyn Manhattan Transit* case as the minimum period during which it would be presumed that the distribution was still incomplete. 1 S.E.C.

within one to three years, questionable.³³ Thus the law is in this respect no different than that applied to resale transactions in privately placed securities.³⁴ It also suffers from most of the very defects criticized in the *Wheat Report*.³⁵

B. The "Residency" Requirement

In order to apply the "issue" concept properly and thus confine the distribution to the state in which the offering is made, it is necessary that each investor-purchaser be in fact a "resident" of that state. This too has proved troublesome. For, according to current doctrine, "... residence means more than merely presence in the State—it requires something resembling domicile."³⁶ In order to establish domicile within a particular state, a person normally "... must be physically present there ..." and, in addition, he "... must intend to make that place his home for the time at least."³⁸ "The requisite animus is the present intention of permanent or indefinite residence in a given place or [state], or negatively expressed, the absence of any present intention of not residing there permanently or indefinitely."³⁹ Therefore if a potential investor moves into the state

at 162-63 (1935). Thus any resales made during that time would be presumed to be a part of the distribution process unless the issuer could prove otherwise. The presumption was based on what appeared to be a statutory presumption of the same concept, i.e., the original one-year exception to the dealer's exemption in § 4(1) of the '33 Act. Sec. Act Release 1459 (1937) indicated a similar appraisal of the holding period with the following words: "[a]ny dealer proposing to participate . . . or deal in [an intrastate] issue within a year after its first public offering, should examine the character of the issue and the proposed or actual manner of its offering with the greatest care in order to satisfy himself that the distribution will not, or did not, involve the making of sales to non-residents." The exception to the dealer's exemption was changed in 1954 to 40 days, see Securities Act § 4(3), 15 U.S.C.A. § 77d(3)(Supp. 1970) for the present version. Sec. Act Release 4434 (1961) appears to have intentionally omitted any reference to a time-period.

³³ Presumably any resale to a non-resident made within this period would be safe, so long as the seller did not intend merely to use 3(a)(11) to avoid registration. Cf., *Wheat Report* at 164-70; Mulford, *supra*, note 31 at 299 (quoted in part).

³⁴ Authorities cited notes 30-33, *supra*.

³⁵ *Wheat Report* at 160-72.

³⁶ 1963 *Special Study* at 571. See, S. REP. NO. 1036, 83d Cong., 2d. Sess. 13 (1954) and 1 LOSS at 598, who on this point states that "... the SEC lawyers who drafted the legislative reports [on the 1954 Amendments to the '33 Act] employed one of the recognized bootstrap techniques of making 'legislative history' by having committees 'approve' an administrative construction." *Id.* at 598, n.141.

³⁷ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 16 (Proposed Official Draft, Part I, May 2, 1967).

³⁸ *Id.* § 18. This applies to a "Domicil of Choice" as distinguished from a "Domicil of Origin." Section 15(a) outlines the requirements as follows: "In addition to legal capacity, acquisition of a domicil of choice requires (a) physical presence as described in § 16 [but note that 'the establishment of a home in a particular dwelling is not necessary . . .'] and (b) an attitude of mind as described in § 18." A "Domicil of Origin" is one "... which a person has at birth," normally that of his father. *Id.* § 14.

³⁹ Price v. Price, 156 Pa. St. 617, 626, 27 A. 291, 293 (1893), cited with approval in, Gilbert v. David, 235 U.S. 561, 569 (1914). RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 18, Comment a (Proposed Official Draft, Part I, May 2, 1967) styles this as "the most important factor in identifying the proper state . . . namely, intention or attitude of mind."

"... with the intention of remaining there for an indefinite time, ... it is to be deemed his place of domicile, notwithstanding he may entertain a floating intention to return [to his former abode] at some future period."⁴⁰ Once having established domicil, however, he keeps it so long as he definitely intends to return at some future point in time. He would retain it even though he had removed himself from his domiciliary state and had disposed of his dwelling-place there.⁴¹

The logical application of this principle may aptly be demonstrated by several hypotheticals cited in Professor Loss's treatise on *Securities Regulation*.⁴² For example, suppose that a California issuer relying on 3(a)(11) sold securities to a military officer who had been stationed in California for a number of years and whose family occupied off-base housing; in other words, except for the concept of domicil⁴³ and possibly federal laws pertaining to the citizenship of military personnel on active duty,⁴⁴ he would exhibit all of the usual appearances of a person "domiciled" in California. Yet, having been commissioned elsewhere, e.g., in his "home-state" of New York, and having the intention of returning at some later date, legally he would be domiciled in New York.⁴⁵ In the case just described, the sale to him would be improper; the exemption presumably would be lost.⁴⁶ Posit the reverse situation, however, where the same issuer sells to a "California" officer stationed in New York, and the sale would meet the requirements of the Act.⁴⁷ Consider further the case of a person who works on Wall Street and who, having maintained residences both in the City and in New Jersey, moves his family to Connecticut immediately after he acquired the securities.⁴⁸ Little more need be said. The concept of "domicil" becomes almost unworkable in situations such as these. For all practical purposes, 3(a)(11) is simply unmanageable for sizable offerings intended to be sold in metropolitan areas the environs of which spill over into neighboring states.⁴⁹

⁴⁰ STORY, CONFLICTS OF LAWS § 46 at 41 (7th ed. 1872) [§ 46 at 50 (8th ed. 1883)], cited with approval in, *Gilbert v. David*, 235 U.S. 561, 569 (1914).

⁴¹ RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 15-19 and Comments [esp. § 19] (Proposed Official Draft, Part I, May 2, 1967). See, 1 BEALE, THE CONFLICT OF LAWS 109-11, 142-54, 181-86 (1935); *Stumberg*, PRINCIPLES OF CONFLICT OF LAWS 16-30 (3rd ed. 1963).

⁴² 1 L. LOSS, SECURITIES REGULATION 599 (2d ed. 1961) [cited generally as 1 LOSS].

⁴³ See, RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 16 and Comment f; 17 and Comment d; 18. (Proposed Official Draft, Part I, May 2, 1967).

⁴⁴ See, e.g., Soldiers' and Sailors' Civil Relief Act of 1940, 50 U.S.C.A. App. § 574 (1968).

⁴⁵ Authorities cited notes 41, 43 & 44, *supra*.

⁴⁶ 1 LOSS at 599; see, Sec. Act Release 4434 (1961); *SEC v. Capital Funds, Inc.*, No. A46-60, Litig. Rel. 1805 (D. Alas. 1960); *SEC v. Big Top, Inc.*, Litig. Rel. 2756 (D. Nev. 1963).

⁴⁷ 1 LOSS at 599; cf., Sec. Act Release 1459 (1937). Note, however, that such a case is unlikely to ever happen in practice.

⁴⁸ 1 LOSS at 599. See, RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 19 & 20 (Proposed Official Draft, Part I, May 2, 1967).

⁴⁹ See, Sec. Act Release 4434 (1961); 1963 *Special Study* at 571-72.

Professor Loss argues that a literal interpretation of the word "resident" in 3(a)(11), rather than the more abstruse notion of domicile, would be more consistent with the basic purposes of the Act.⁵⁰ As it now stands, the present construction makes the issuer practically a guarantor of each purchaser's "domicil."⁵¹ For, under current sanctions, once a sale to a "non-resident" has been consummated, the issuer, having lost his exemption, must be prepared to rescind all prior transactions and redeem the purchase money paid—even for those made to *bona fide* "residents."⁵² In Loss's view, it would be much more sensible to construe "resident" as a person who maintains a more or less permanent dwelling-place within the state;⁵³ intentions then, "floating" or otherwise, would be immaterial. Not only would such a construction tend to satisfy the administrative need for certainty, but also it would be more in keeping with the concept of a wholly "intrastate" exemption.⁵⁴ Actually, the matter has never been litigated;⁵⁵ until it is though, counsel must continue to follow the Commission's suggested interpretation. In any event, it again illustrates the difficulties of using 3(a)(11).

C. The Requirement of Doing Business and Investing the Proceeds Within the State

A somewhat disparate but nonetheless indispensable element of the law on this subject is the requirement that the offering be restricted to the state in which the issuer is both resident or incorporated and doing business. This of course defines the relevant state to which distribution must be limited. It too has caused problems. For one, the phrase "doing business," which appears in many diverse statutes, can be read in a variety of ways. Generally its meaning will vary in accordance with the policies being promoted by the statute under construction.⁵⁶ For purposes of service of process, for example, a corporation may be considered "doing business" within a state if it is "present" in, or has sufficient "minimum contacts" with, that state.⁵⁷ Slightly more permanent contacts, such as plants, offices, resident sales personnel, and the like, might be necessary before a foreign corporation can be taxed or compelled to "qualify" in

⁵⁰ 1 LOSS at 598-99.

⁵¹ *Id.* at 604-05.

⁵² See text accompanying note 79, *infra*.

⁵³ 1 LOSS at 599. See 1 BEALE, *supra* note 41 at 109-11; RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 30 & Comment (Proposed Official Draft, Part I, May 2, 1967).

⁵⁴ 1 LOSS at 599.

⁵⁵ *Id.* at 598.

⁵⁶ *Id.* See, *Chapman v. Dunn*, 414 F.2d 153, 157 (6th Cir. 1969); 1 BEALE, *supra* note 41 at 109-22; STUMBERG, *supra* note 41 at 16-18.

⁵⁷ See, e.g., *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957).

order to operate there.⁵⁸ In the case of 3(a)(11), the standard appears to be perceptibly more stringent: "[i]n view of the local character of the . . . exemption, the requirement that the issuer be doing business in the state can only be satisfied by the performance of *substantial operational activities* in the state of incorporation."⁵⁹ On more than one occasion, the Commission's staff has used the word "principal" in characterizing the amount of activities required.⁶⁰ And recently, the Sixth Circuit, in *Chapman v. Dunn*,⁶¹ used the term "predominant"⁶² in its description of the standard. Although the *Chapman* terminology may be labeled *dictum* in light of the facts of that case,⁶³ still it points to the degree of local connections which the issuer must have before he can sell unregistered securities in that locality.

At first glance, one may question the concern over terminology. But more than words are at stake. Many genuinely "local" enterprises do a considerable amount of interstate business. To restrict the exemption to firms whose activities are confined solely to their state of incorporation would hardly be defensible from either a statutory or a policy standpoint; there are no persuasive reasons for going to this extreme.⁶⁴ By the same token, it would clearly defeat the purpose of the exemption, i.e., "local financing by local industries,"⁶⁵ to require only the minimal presence deemed sufficient under other statutes.⁶⁶ The problem then is where to draw the

⁵⁸ See, e.g., *General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *Nippert v. City of Richmond*, 327 U.S. 416 (1945); *Eli Lilly & Co. v. Sav-On-Drugs, Inc.*, 366 U.S. 276 (1961), *rehearing denied*, 366 U.S. 978 (1961); *Union Brokerage v. Jensen*, 322 U.S. 202 (1944).

⁵⁹ Sec. Act Release 4434 (1961).

⁶⁰ 1963 *Special Study* at 571; McCauley, *supra* note 10 at 950 [Assoc. Gen. Counsel].

⁶¹ 414 F.2d 153 (6th Cir. 1969).

⁶² 414 F.2d at 159.

⁶³ In *Chapman* the issuer, a receiver for an Ohio corporation, was a Michigan resident who was selling, to Michigan residents, fractional undivided interests in oil and gas leases to properties located in Ohio. The court held that the Michigan issuer was not doing business within the state for purposes of 3(a)(11) ". . . when *all* the income producing property to which the securities [applied was] located outside the state. . . ." [emphasis added.] 414 F.2d at 159. Hence the court was merely applying the current standard as enunciated in Sec. Act Release 4434 (1961), which it quoted, and *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957), which it noted at some length. In light of this, the use of the word "predominant" at one place in the opinion may be considered unnecessary to the holding. *But see*, text at note 67, *infra*. Nevertheless it has caused concern among local counsel.

⁶⁴ "The fact that the word 'only' does not modify the 'doing business' clause indicates quite clearly that the issuer's business need not be *confined* to the state in which it is resident or incorporated." [emphasis in original.] 1 LOSS at 601. Thus the SEC would have little statutory justification for interpreting the phrase in this manner. See, McCauley, *supra* note 10 at 950. Moreover, such a construction would arguably preclude a local issuer who had goods or sales personnel permanently located outside the state from ever using 3(a)(11). *But see*, Sec. Act Release 1459 (1937).

⁶⁵ Sec. Act Release 4434 (1961); Sec. Act Release 1459 (1937); Meeker, *Advising Your Client on Securities Problems*, 28 OKLA. B. A. J. 1863, 1868 (1957); *see*, text accompanying notes 156-64, *infra*.

⁶⁶ See text accompanying notes 56-58, *supra*.

line. "Substantial operational activities" within the state implies that a figure less than—but approaching—50% of the company's total income-producing assets, i.e., only 30-49%, need to be located there. "Principal" or "predominant," however, suggests a much higher minimum percentage, well in excess of 50%. Probably the latter was what Congress had in mind when it enacted 3(a)(11).⁶⁷ Equally important, the "doing business" requirement is not a purely formal condition which the issuer must satisfy in order to avail himself of the exemption. It has also been construed to require that the investor have a financial ". . . interest in the issuer's separate business within the state."⁶⁸ This means that most of the proceeds of the offering must actually be invested in income-producing assets located within the state.⁶⁹ Thus a local enterprise which desires to expand its operations into nearby states by acquiring out-of-state companies or their assets would be precluded from doing so with 3(a)(11) funds, even though its principal operations were conducted locally.⁷⁰ In effect then, the "words" determine who qualifies for the exemption and, to a limited extent, how the proceeds must be allocated. Such is the law of 3(a)(11).

II. ACTUAL PRACTICES RESPECTING INTRASTATE OFFERINGS

A. Limited Utility of the Exemption

Having explored in some detail the content of the rules governing intrastate exemptions, it should have become apparent that, for many financial undertakings, 3(a)(11) is simply unavailable. Either because of the state in which the issuer is incorporated,⁷¹ the size of the projected offering, the geographical proximity of neighboring states, the scale of the issuer's operations, or the opportunities for which venture capital is sought, compliance with the requirements specified above often cannot be obtained. Perhaps this is as it should be. No doubt there is an overriding federal policy in favor of registration and its consequent disclosures whenever a

⁶⁷ See text and sources accompanying notes 156-64, *infra*.

⁶⁸ Sec. Act Release 4434 (1961).

⁶⁹ *Id.*; *Chapman v. Dunn*, 414 F.2d 153, 159 (6th Cir. 1969); *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957); see discussion note 63, *supra*.

⁷⁰ Authorities cited, note 69, *supra*. Another factor to be considered here is the time frame during which the proceeds are to be allocated. For example even though the issuer plans on using most of the offering's proceeds locally, e.g., 85%, still he could conceivably jeopardize the offering by investing the first portion received, i.e., 15%, in an out-of-state venture. This is because the SEC might be reluctant to accept his claim that the rest of funds have been designated for local use only. The Commission took this position in *Tait v. North American Equitable Life Assurance Co.*, 92 Ohio L. Abs. 551, 25 Ohio Ops.2d 451, 194 N.E.2d 456 (C.P. 1963), *aff'd per curiam*, 195 N.E.2d 128 (Ohio App. 1963), *app. dismissed*, 176 Ohio St. 240, 199 N.E.2d 3 (1964).

⁷¹ Many local concerns still find it advantageous to incorporate outside the state in which their principal business activities are conducted, e.g., such as in Delaware.

substantial block of investment securities is to be offered to the public;⁷² this is especially true where distribution through organized channels is contemplated.⁷³ Because of this, the SEC has had more than adequate justification for construing 3(a)(11) as narrowly as it obviously has.⁷⁴ Indeed, it would have had little authority for doing otherwise. As a result of such a posture though, the use of 3(a)(11), which has been characterized as being "loaded with dynamite,"⁷⁵ should be viewed with the utmost caution.

Moreover the sanctions that can be invoked against its misuse reinforce the admonition. They can be severe. The following constitutes the measures which may be taken once the SEC discovers a violation:

- (1) revocation of broker-dealer registration for the principal underwriters and distributing dealers;⁷⁶
- (2) threat of an injunction to prohibit further distribution until a registration statement is filed;⁷⁷
- (3) compulsory disclosure of the issuer's contingent liability under section 12(1) with respect to those shares or units already sold in violation of section 5;⁷⁸
- (4) SEC insistence on an offer of rescission and redemption for all transactions consummated prior to the violation, including those involving residents of the state;⁷⁹ and
- (5) criminal prosecution under section 24.⁸⁰

In sum, although a technical violation may pass undetected due to the absence of a filing requirement,⁸¹ the price of a 3(a)(11) failure is hardly worth the risk of even one innocent mistake.

There are practical reasons, in addition to those previously mentioned,

⁷² Securities Act *preamble*, 48 Stat. 74 (1933).

⁷³ 1963 *Special Study* at 571; *cf.*, Sec. Act Release 1459 (1937).

⁷⁴ 1 LOSS at 591, 604; Sosin, *supra* note 10 at 111, 112.

⁷⁵ Gadsby, *The SEC and the Financing of Small Business*, 14 BUS. LAW. 144, 148 (1958) [Former Chairman of the SEC.]

⁷⁶ Securities Exchange Act of 1934, § 15(b)(5)(D), 15 U.S.C.A. § 78o(b)(5)(D) (Supp. 1970). *See, e.g.*, *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359 (6th Cir. 1970); *Whitehall Corp.*, 38 S.E.C. 259 (1958); 1 LOSS at 604.

⁷⁷ Securities Act § 20, 15 U.S.C.A. § 77t (1963); *see*, 1 LOSS at 604.

⁷⁸ 1 LOSS at 604; *see, e.g.*, *Texas Glass Mfg. Corp.*, 38 S.E.C. 630, 634-35 (1958).

⁷⁹ 1 LOSS at 604; *cf.*, *Edsco Mfg. Corp.*, 40 S.E.C. 865 (1961).

⁸⁰ Securities Act § 24, 15 U.S.C.A. § 77x (1963). It should be noted that proof of wilfulness would be required under § 24. Loss also states that there have been relatively few criminal prosecutions of any kind under the Securities Act, 1 LOSS at 603, 1994.

⁸¹ 1963 *Special Study* at 571-75. In the 1963 *Special Study*, the SEC recommended legislation which would have obligated issuers to give "notice of substantial offerings" under 3(a)(11) before they were made. This proposal was never explicitly adopted. It should be noted, however, that many issuers using 3(a)(11) are likely to become subject to the reporting requirements of the '34 Act within a relatively short time after the proceeds are received, *see text and sources accompanying notes 151-53, infra*. Hence the Commission will eventually become aware of the fact that a sizable 3(a)(11) offering was made anyway, even though no one actually complains about improper sales, and so forth.

which limit the usefulness of the exemption. An obvious one is that frequently alternative exemptions are available for the same issue. Private offerings under section 4(2), "small" offerings under Regulation A,⁸² and conceivably even section 3(a)(10) exchange offerings which are administered and approved by state supervisory authorities,⁸³ might be placed in this category. The relative merits and safety afforded by each, of course, would depend upon the issuer's circumstances and the anticipated market for his securities. But a private offering, if feasible, would seem to be notably less hazardous than its intrastate counterpart, now that adoption of the *Wheat Report's* proposed rules is in the offing. The basis for this assertion is two-fold: (1) Many underwriters and dealers probably are, or should be, considerably more familiar with their customers' circumstances in the case of a private offering than they would be in a 3(a)(11) situation.⁸⁴ This being so, they are in a much better position to evaluate the potential impact of an intended resale on the availability of the issuer's 4(2) exemption. Also, (2) assuming that the *Wheat Report's* proposals are put into effect and that similar rules governing 3(a)(11) are not, then there would appear to be less risk of investor resales imperiling an otherwise valid offering made under the former exemption than there would be under the latter. This observation follows not only because of the specificity with which the *Wheat Report's* rules are stated,⁸⁵ but also because of the broker-dealer's greater knowledge and duty of inquiry under the new rules.⁸⁶ As a consequence, where there is a realistic choice between the two, the 4(2) exemption would generally seem preferable. Furthermore, the same could always be said about Regulation A offerings.⁸⁷

Another reason tending to discourage intrastate offerings is a bit more subtle but equally compelling: because of the risks involved, many underwriters will not handle them.⁸⁸ NASD review of those offerings underwritten by its members⁸⁹ is illustrative of the general apprehension regard-

⁸² Securities Act § 3(b), 15 U.S.C.A. § 77c(b)(1963), and SEC Reg. A (explicitly), 16 C.F.R. § 162.11 (1970).

⁸³ Securities Act § 3(a)(10), 15 U.S.C.A. § 77c(a)(10) (1963). See, e.g., Ohio Rev. Code Ann. § 1707.04 (Page 1964). Admittedly, this is seldom a practical alternative, except in very unusual circumstances.

⁸⁴ On the presumption of the sophisticated investor, see text and sources accompanying notes 166-70, 173-75, *infra*.

⁸⁵ For a discussion of the objective standards of the new rules, see text accompanying notes 122-36, *infra*.

⁸⁶ See text at note 84, *supra*, and text and sources at notes 133-35, *infra*, on the broker's obligations.

⁸⁷ 1 Loss at 603, text at n.166.

⁸⁸ 1963 *Special Study* at 572. One prominent local underwriting firm, for example, handles only debt securities under 3(a)(11) because its officers feel that offerings of equity securities are simply too difficult to control properly.

⁸⁹ CCH NASD MANUAL ¶ 2151.02 at 25-27. This is one aspect of a continuing review by the Board of Governors of the fairness of all offerings which NASD members

ing their use. Consequently, an issuer who is reluctant to turn to underwriters specializing in such offerings⁹⁰ may simply be directed to other modes of financing by those with whom he regularly deals. A third factor which may affect the utility of 3(a)(11) is the onerousness of a particular state's blue sky law. In some cases, disclosure requirements of the local securities law may be almost as exacting as the federal. In Ohio for example, registration by qualification,⁹¹ which calls for much of the same information as the '33 Act,⁹² would be required of those issuers unable to meet the conditions for registration by description.⁹³ At a minimum, this would apply to all newly-formed companies and to existing concerns whose average net earnings fall below statutory standards.⁹⁴ Since Ohio, like other states, permits the filing of a federal registration statement to serve as a substitute for the prescribed forms,⁹⁵ an issuer who is obliged to register by qualification might as well file under both laws, especially in questionable cases.⁹⁶ The differences in cost, time and paper work, although substantial enough, probably do not warrant the risk of avoiding federal registration. In conclusion, an issuer would be well advised to use something other than 3(a)(11), unless he clearly fits the description of a "local industry" seeking "local financing."

In spite of all that has been said, the available evidence indicates that 3(a)(11) is still widely employed in certain states.

Some indication of the volume of offerings of this general character is afforded by the experience of those States which do not exempt small or private issues from the permit requirements of their securities laws. One such State, California, issues approximately 15,000 permits a year. This may be compared with approximately 2,307 registration statements and 1,065 regulation A offerings filed with the Commission from the entire country during fiscal 1962.⁹⁷

underwrite or participate in. Accordingly, the member involved must submit the prospectus, all offering circulars, his notice of intention or other written documents with respect to underwriting arrangements, compensations, etc.

⁹⁰ Securities Exchange Act of 1934, § 15(a), 15 U.S.C.A. § 78o(a)(Supp. 1970), and 1963 *Special Study* at 573. Frequently these underwriters do nothing else but promote local issues; hence they claim exemption from broker-dealer registration by virtue of § 15(a). Also, see discussion note 105, *infra*.

⁹¹ Ohio Revised Code Ann. § 1707.09 (Page 1964).

⁹² *Id.* § 1707.09(A)-(J). Cf., Securities Act § 7, 15 U.S.C.A. § 77g(1963), & Schedule A. Although in practice state corporate securities agencies seldom call for all of the detailed disclosures that may be required by the SEC, still many local counsel treat them in much the same way, especially with respect to the information contained in offering circulars.

⁹³ Ohio Revised Code Ann., § 1707.05, .08 (Page 1964).

⁹⁴ *Id.* § 1707.05(A).

⁹⁵ *Id.* § 1707.09(K), .21.

⁹⁶ The Ohio Division of Corporate Securities occasionally requires, as a part of the registration process, a "no action" letter from the SEC for any "questionable" 3(a)(11) offering, i.e., questionable in the sense that the examiner suspects that a particular issuer might be doing too much out-of-state business.

⁹⁷ 1963 *Special Study* at 571. "There is no way of knowing how many of these offerings occur every year, but the number is unquestionably substantial in view of the fact that there

The number of permits issued, of course, does not mean that California had 15,000 3(a)(11) "offerings," as most of these permits were undoubtedly issued for closely-held corporations. Nonetheless the figure does suggest that there are many such offerings.⁹⁸ Ohio has been similarly prolific. In 1969 alone, for example, it has been estimated that possibly as many as 780 such offerings were made throughout the state.⁹⁹ And a number of them are sizable.

Notwithstanding the general exclusory rule of the editors of the financial manuals [because the editors generally feel that 3(a)(11) issues are too small to be of public interest, one such manual] alone listed during 1961 at least 90 offerings [which were] apparently made pursuant to the intra-state exemption. Of these 90, 15 were for amounts totaling at least \$1 million, and another 15 were in amounts ranging from \$500,000 to \$1 million.¹⁰⁰

The reasons for this phenomenon are varied, but in the main they may be attributed to the following factors: (1) the existence of a broad, cohesive, geographic area with a thriving, relatively self-contained industrial and agricultural base—all within the territorial boundaries of a single state; (2) the existence of a large, affluent, and urbanized population whose income is equitably distributed, as compared with other states, and whose proclivity for investing is predictable;¹⁰¹ (3) the general feeling that federal registration is more laborious and, due to the SEC backlog, considerably more time-consuming. Especially because of the latter, issuers urgently in need of additional working capital may be pressed into relying upon 3(a)(11), even though prudence might dictate a different course of action. Other factors may also exert some influence on the utility of the exemption.¹⁰² Ohio, for example, formerly did not require a written ex-

are over a million corporations in the United States, most of which are not represented on trading markets." *Id.*

⁹⁸ The 1963 *Special Study* notes that "[i]n 1957, the regional offices of the Commission made a 'rough estimate' of the number of filings that would be made annually in their respective regions if issuers making offerings pursuant to [3(a)(11)] were required to notify the Commission. The Chicago regional office, for example, estimated 921 such filings . . . ; the Fort Worth regional office estimated 510. . . ." *Id.* at 573, n.225.

⁹⁹ This figure too is a very "rough estimate," based on the total filings with the Ohio Division of Corporate Securities during 1969. The Division guessed that about 15% or more of the 5200 filings were 3(a)(11) offerings (i.e., 1566 registrations by qualifications, plus 3651 registrations by description=5217; 15% of 5200=780). Again this is by no means an accurate figure, but it is an indication of how frequently the exemption is used. Also, some of these offerings easily compare with the data cited in the 1963 *Special Study* at note 100, *infra*. See, e.g., Sosin, *supra* note 10 at 112-14.

¹⁰⁰ 1963 *Special Study* at 573.

¹⁰¹ The general conditions mentioned here are particularly prevalent in those few states where the exemption is often used, e.g., California, Texas, Ohio, etc. Compare the situation existing on the Eastern seaboard, or in the South where the conditions are not quite so propitious (i.e., the geography, location of population centers, or general economic base simply do not lend themselves to large, publicly distributed 3(a)(11) issues).

¹⁰² In Ohio, for example, there is no statutory requirement that each purchaser be given a prospectus. Cf., Securities Act § 5(b), 15 U.S.C.A. § 77e(b)(1963).

amination of its securities salesmen.¹⁰³ Consequently, many intrastate underwriting specialists¹⁰⁴ relied upon a part-time, non-professional sales force for the allotment of their issues amongst the latter's friends and neighbors. Such practices are likely to change. Due to the exam requirement, the emergence of SECO rules,¹⁰⁵ and possibly the tight money market, more and more of these dealers will be inclined to register as NASD members or else discontinue altogether. In either event, their participation in such undertakings should tend to decrease in the future. But the present situation in Ohio illustrates both the pervasiveness of intrastate offerings and the manner in which they are often conducted.

B. Local Practices to Insure Compliance

Since 3(a)(11) is still so extensively used in certain areas, the practices employed to comply with it deserve some attention. Accordingly, the following is a list of such practices:

1. *Basic Method: Right to Refuse Issuance or Registration of Transfer.* It is generally assumed that the most effective means of guarding against improper sales is the reservation, on behalf of the issuer, of a right to refuse issuance—and registration of transfer on corporate books—of the shares purchased by a non-resident.¹⁰⁶ This right, which is included in the subscription agreement, is usually reserved for a period of 18 to 24 months or longer. It enables the transfer agent to monitor all transactions in the security, i.e., both subscriptions and transfers, and to invoke the right whenever the address, occupation, or other circumstances suggest that the purchaser may be domiciled in another state.¹⁰⁷ Ordinarily, since very little trading develops anyway until long after the distribution is completed, such monitoring does not represent a burdensome administrative procedure. It is obviously no panacea though. It does not deter improper solicitation by errant salesmen, nor does it safeguard against

¹⁰³ This requirement was adopted in October, 1969; Ohio Revised Code Ann. § 1707.16 (E) (Page Supp. 1970).

¹⁰⁴ See note 90, *supra*.

¹⁰⁵ SECO rules are issued pursuant to § 15(b)(8) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78o(b)(8) (Supp. 1970), for those broker-dealers registered under § 15 who have not joined the NASD (see § 15A). Unless a broker-dealer deals strictly in local issues and claims exemption from registration under § 15(a), he would be subject to these rules.

¹⁰⁶ See, ISRAELS & GUTTMAN, MODERN SECURITIES TRANSFERS §§ 4.06, 8.11 & 9.01-06 (1967) and UNIFORM COMMERCIAL CODE § 8-401 (1962 Official Text) on the issuer's duty to register transfer. [The UNIFORM COMMERCIAL CODE (1962 Official Text) will hereinafter be cited as the UCC].

¹⁰⁷ "The reasonableness of this type of restriction [on transfer] has been upheld in state courts." ISRAELS & GUTTMAN, *supra* note 106, § 4.06 at 405 [citing cases on 4(2) securities]. Moreover, the resident subscriber, if he is aware of the problem, should be reluctant to sell anyway; for an improper sale would not only be a breach of his covenant, but it would also make him a statutory underwriter. Also note that this type of restriction is enforceable only against original subscribers and transferees with knowledge of it, see UCC § 8-204 (quoted below) and text accompanying notes 108-09, *infra*.

administrative oversight and purchaser misrepresentation. Further and perhaps more significant, the right, which is a restriction on transfer, is not binding upon a subsequent transferee unless he has actual knowledge of it.¹⁰⁸ Therefore, where a resident investor has contracted to sell to a non-resident, notwithstanding his covenant to the contrary, his promisee should be able to compel transfer, even though to do so might endanger the issuer's exemption.¹⁰⁹ Hence other control measures, particularly the restrictive legend on the security certificates,¹¹⁰ are still necessary.

2. *Legends on the Prospectus.* Legends on the prospectus, the subscription agreement, and soliciting materials always contain a provision stating, *inter alia*, that the offering is made pursuant to a 3(a)(11) exemption and that the purchaser "agrees to buy for investment and other than with a view to resale or other transfer to non-residents" for at least two to three years.¹¹¹ Although usually considered a matter of form and seldom understood by the average investor, nevertheless these legends are important in several respects. They provide some degree of constructive notice essential to the enforceability of the aforementioned right to refuse issuance or registration of transfer. In addition, they may actually forewarn an unsuspecting subscriber of the impropriety of his subscription or intended resale. They may also advise the less informed of the character of the issue. Therefore, even though not fully appreciated by the average investor, they are of unquestionable value.

3. *Statements of Residency and Letters of Investment Intent.* A *pro forma* declaration of residency and investment intent is occasionally provided for in the subscription agreement, but these are generally thought of as worthless.¹¹² Since they may reinforce the notice provisions of the prospectus' legend, inclusion is desirable; however, they hardly warrant the use of extra printed forms.

¹⁰⁸ UCC § 8-204 reads: "Unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it." See, UCC § 1-201(25); ISRAELS & GUTTMAN, *supra* note 106, § 4.06 at 407-08; Ohio Revised Code Ann. § 1701.25(B) (Page 1964).

¹⁰⁹ See, UCC §§ 8-301, -316; ISRAELS & GUTTMAN, *supra* note 106, § 4.03, .06; Whitehall Corp., 38 S.E.C. 259, 268-70 (1958). See also, Comment to UCC § 8-204.

¹¹⁰ See text accompanying notes 113-15, *infra*.

¹¹¹ As to the reasons for this, see text and sources accompanying notes 27-34, *supra*. Sometimes the time period is omitted and the transfer agent merely requires an opinion of counsel before registration of transfer is permitted.

¹¹² This is particularly so in the case of 3(a)(11) securities.

"... [I]t is the practice in such cases to obtain from each purchaser in a private or intrastate offering a so-called 'investment letter' stating that he is acquiring the securities for investment and not with a view to the distribution thereof to the public. The Commission does not regard a simple statement to that effect as sufficient, and perhaps it is right. I know of a case where a man signed such a statement at a settlement on the 20th floor of an office building in New York, picked up his stock certificates, went downstairs to the ground floor and turned the certificates over to his broker with an order to sell them on the Stock Exchange at the market."

Mulford, *supra*, note 31 at 299.

See, Sec. Act Release 4434 (1961).

4. *Restrictive Legend on the Certificates.* A legend on stock or bond certificates, which states that they were distributed pursuant to a 3(a)(11) exemption and which notes the issuer's right to restrict ownership to *bona fide* residents, would seem to be a fairly effective method of protecting the offering. It certainly would inhibit casual inadvertent resales. Yet rarely is this done locally. Probably the best explanation for this is that many counsel instinctively feel that such legends reflect adversely on the value of the securities. Be that as it may, since the Commission has all but made them mandatory for privately placed securities,¹¹³ similar treatment for 3(a)(11) securities now seems in order.

Careful precautions by the issuer of the securities will be essential to assure that a public offering does not result through resales Although such assurance cannot be obtained merely by the use of an appropriate legend on stock certificates . . . or by other procedures in common use, such as appropriate instructions to transfer agents, these devices may serve a very useful policing function. When the securities are subsequently transferred . . . , the use of the legend on the certificates helps not only to prevent possible violation of the Act but also to alert the buyer to the restricted character of the securities he has acquired. It may thus assist in the prevention of fraud.

. . . .
... *The Commission will regard the presence or absence of such legend . . . as a significant indication of whether the circumstances surrounding an offering are consistent with exemption under section 4(2) of the Act.* [Emphasis added.]¹¹⁴

Moreover, as previously noted, without such a legend, the issuer may be thwarted in his attempt to prevent improper resales and thus to control the distribution of his securities.¹¹⁵

5. *Educating Dealers and Salesmen.* All of the aforementioned procedures ". . . serve a very useful policing function"¹¹⁶ and therefore ought to be employed. None of them though are foolproof. Consequently, educating those engaged in the distributive process is still a very important part of counsel's role in the undertaking. Instruction to dealers and salesmen about the necessity for limiting offers and sales to residents, with emphasis on the seriousness of the offense if the exemption is lost, should be made at periodic intervals.¹¹⁷ Only in this way can the issuer be con-

¹¹³ SEC Securities Act Release No. 4997 (Sept. 15, 1969) [hereinafter cited as Sec. Act Release 4997 (1969)].

¹¹⁴ *Id.* Although obviously written for 4(2) securities, these statements would appear to apply with equal force to 3(a)(11) securities.

¹¹⁵ See text and sources accompanying notes 107-09, *supra*.

¹¹⁶ Sec. Act Release 4997 (1969).

¹¹⁷ Local counsel report that *United States v. Wolfson*, 405 F.2d 779 (1968) is an excellent incentive for keeping salesmen attentive at such lectures. Some underwriters and dealers require signed statements to the effect that the salesman is aware of the restrictions in a particular 3(a)(11) offering.

fident that he has taken every reasonable step to insure compliance with the Act.

III. POTENTIAL APPLICATION OF THE WHEAT REPORT'S PROPOSED RULES TO 3(a)(11)

The foregoing review of the basic rules and practices concerning intrastate offerings was undertaken primarily for the purpose of indicating fundamental points of similarity between 3(a)(11) and the private offering exemption authorized in section 4(2) of the '33 Act. To anyone familiar with the gloss that has been accumulating over the years respecting the latter, their likeness should be evident.¹¹⁸ The basic question of subjective investment intent, the uncertainty surrounding the time required before resale is allowed, the difficulty of deciding what constitutes a "distribution" when questionable transfers are made—all of these are problems common to the use of both exemptions.¹¹⁹ Indeed, even the techniques that have been developed to preserve them are similar.¹²⁰ And, as earlier noted, both suffer from many of the same defects.¹²¹ Now that the objective standards set forth in the *Wheat Report's* proposed rules are expected to remedy many of the difficulties formerly experienced under section 4(2), it seems desirable to consider the potential application of these standards to common questions arising under 3(a)(11). In order to do this, it is first necessary to outline the proposed rules, insofar as they are pertinent to the point under consideration.

A. Description of the Proposed Rules

The methodology of the new system is to provide objective tests in lieu of expositive phrases for the definition of key statutory terms. By this technique, the system effectively excludes certain specifically delimited transactions from the general prohibitions of the '33 Act. It does not, however, affect the basic rules regulating the initial offering and sale of privately placed securities; these remain unchanged.¹²²

Proposed rules 160, 161 and 162¹²³ contain the basic framework.

¹¹⁸ The *Wheat Report* has an excellent summary of the law on 4(2), *id.* at 160-77. For additional sources, see notes 30-31, *supra*, and 173-74, *infra*.

¹¹⁹ The "integration" problem, see text and sources at notes 11-13, *supra*, is common to both. The "change of circumstance" doctrine is an integral part of the question of investment intent, see *Wheat Report* at 166-70 and text and sources at note 30-31, *supra*. Others could be mentioned, such as whether "gifts" to non-residents invalidate the exemption, see 1 LOSS at 593, n.124.

¹²⁰ Mulford, *supra*, note 31; see generally, text and sources accompanying notes 106-17, *supra*.

¹²¹ See authority cited note 35, *supra*, and accompanying text.

¹²² For a brief description of the basic requirements concerning 4(2) offerings, see text and sources accompanying notes 166-70, 173-75, *infra*. *A fortiori*, a public intrastate offering would not be subject to the new rules.

¹²³ Sec. Act Release 4997 (1969). Hereinafter, the proposed rules will be cited without further reference to this release, except where appropriate.

Rule 160 includes within the definition of statutory "underwriter"¹²⁴ ". . . any person who disposes of a restricted security (as defined in Rule 161) in a distribution (as defined in Rule 162)." "A 'restricted security means any security acquired directly or indirectly from its issuer, or from an affiliate of its issuer [i.e., a control person],¹²⁵ in a transaction or chain of transactions *none* of which was a public offering or other public disposition."¹²⁶ Ordinarily a "restricted security" will remain such for a period of five years after which it ceases to be so. The termination of this status, however, is expressly conditioned on the issuer's gross receipts. If he has received less than \$250,000 in "gross revenues from operations" during each of the five consecutive years following the date of the initial offering, then the securities retain their restricted status until the condition is met. The reason for the inclusion of this additional restriction was to distinguish between active going-concerns and bogus corporate shells. Without the distinction, the Commission feared that the latter might be used to circumvent the rules.¹²⁷ Rule 162 defines the term "distribution" in section 2(11) as ". . . any *public offering* of a security *excepting only* a transaction which meets *all* of the following requirements:"¹²⁸

(1) *Qualified Issuer.* The issuer must be a "qualified" issuer under Rule 163 at the time of the transaction, i.e., it must be a "reporting" company or one which is obligated to file regular reports on its business affairs under § 13 or § 15(d) of the Securities Exchange Act of 1934. In general, this would include any corporation with a class of securities listed on a national securities exchange, § 12(b), or registered under § 12(g), or subject to § 15(d) of the '34 Act.¹²⁹ Note, however, that if a reporting issuer becomes delinquent in his reporting, i.e., "deficient or tardy," or if he becomes subject to certain administrative proceedings before the SEC, he could lose his status as such, either temporarily or permanently.

(2) *Holding Period for Restricted Securities.* Generally the required holding period for restricted securities "beneficially owned by the offeror"

¹²⁴ Reference should be made to authorities cited notes 18-19 *supra*.

¹²⁵ Rule 101 of the proposed rules defines an "affiliate" or a "person 'affiliated' with, a specified person, [as] a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." Sec. Act Release 4997 (1969). Cf., Securities Act, §§ 2(11) & 15, 15 U.S.C.A. §§ 77b (11) & 77o (1963).

¹²⁶ Rule 161(a) [emphasis added.] This would clearly exclude most 3(a)(11) securities from the operation of the new rules, see note 122, *supra*, as the "restrictions" on their disposition emanate from different sources.

¹²⁷ *Wheat Report* at 203.

¹²⁸ Sec. Act Release 4997 (1969) [emphasis added.] Section 2(11) is quoted at note 18, *supra*.

¹²⁹ Securities Exchange Act of 1934, 15 U.S.C.A. § 78a *et seq.* (1963). As to the § 12(g) requirements, see note 151, *infra*, and accompanying text.

is "at least one year prior to the transaction" or sale.¹³⁰ This general rule, however, must be qualified somewhat. It is limited to situations where the "offeror" (which includes his immediate family and dependent relatives, plus controlled trusts, estates, and corporations)¹³¹ has paid the "full purchase price of such securities" and where he has not ". . . purchased or agreed to purchase any other restricted securities of the same issuer, whether or not of the same class as the securities offered by him."¹³² Rule 162 goes on to provide specific holding periods for almost every type of investment security and for most of the various ways in which such securities could have been acquired, e.g., stock dividends, convertible securities, pledged securities, those acquired in business reorganizations, and those acquired by reason of death, gift or trust termination.

(3) *Unsolicited Brokerage*. This restriction attempts to limit the methods by which an offering can be made to those normally associated with ordinary trading transactions. It is designed to preclude the kind of intensive sales campaign which is often employed in circulating large blocks of securities among the investing public.¹³³ Accordingly, the rule in substance provides that "[t]he offering must be made through a broker acting as agent for the seller [and not as a principal in his own behalf.] The broker may not solicit buy orders [only sell orders] and may charge no more than the minimum commission applicable on the exchange on which the security is listed or no more than the minimum commission applicable on the New York Stock Exchange if the security . . ."¹³⁴ is traded over-the-counter. In addition, "[t]he offeror may not solicit or arrange for others to solicit buy orders and [he] may not make any payment except the specified commission in connection with the transaction."¹³⁵

(4) *Limitation on Amount of Securities*. The amount of securities involved in the transaction must not be ". . . substantial in relation to the number of shares or units of the security outstanding and the aggregate volume of trading in the security." By the figures summarized below, this rule in effect limits the quantity of securities that may be publicly sold by the offeror within any given six-month period to the following:

¹³⁰ Rule 162(c)(1).

¹³¹ Rule 162(b).

¹³² Rule 162(c)(1). This is the solution to the "fungibility" problem; see, *Wheat Report* at 172-74.

¹³³ See *Wheat Report* at 20-1.

¹³⁴ Quote in the text is the SEC's summary of Rule 162 (a)(3) in Sec. Act Release 4997 (1969).

¹³⁵ *Id.* The broker's part in the transaction is provided for in Rule 164. In effect it exempts the broker from the provisions of § 5 (see § 4(4) of the '33 Act) where he has effected a transaction ". . . acting as agent for the account of (1) an affiliate of the issuer of the securities which are the subject of the transaction, or (2) any person disposing of a restricted security, as defined in Rule 161 . . . [but] only if [he] has made reasonable inquiry of his customer and has no grounds for believing and does [not ?] believe that the transactions constitute a distribution as defined in Rule 162."

(a) for over-the-counter securities, approximately 1% of the shares or units outstanding; and (b) for securities traded on an exchange, the lesser of (i) 1% of the shares or units outstanding or (ii) the "largest aggregate reported volume of trading on [all] securities exchanges during any one week within the four calendar weeks preceding . . ." the placing of a sell order.¹³⁶

To recapitulate, a transaction meeting the requirements specified in subparagraphs (1) through (4) of Rule 162(a) will not be deemed a "distribution" and the person effecting such a transaction will not be labeled a statutory "underwriter." Hence he will be exempted by section 4(1).¹³⁷ In simpler words, any purchaser of a reporting company's restricted securities, including a control person, will usually be permitted to sell limited quantities thereof in an ordinary trading transaction after the one year holding period has elapsed. He may do this without registration and without affecting the issuer's 4(2) exemption.¹³⁸

As previously intimated, the significance of the above rules lies in the objectivity with which key statutory terms are defined. By means of these tests, both the SEC and the securities industry should be able to determine—quickly and definitively—whether or not a person contemplating resale of restricted securities was about to engage in a prohibited transaction. No longer will the "passage of indeterminate amounts of time"¹³⁹ and the seller's state of mind or other nebulous circumstances¹⁴⁰ be controlling. No longer will the "lack of objective tests" provide an "unfortunate leeway for the unscrupulous" by tempting them to "cut the statutory corner."¹⁴¹ Furthermore, no harm should befall the investing public as a result of these new rules. Since they ". . . operate to inhibit the creation of public markets in securities of issuers which do not disclose information to the public in appropriate filings with the Commission . . .,"¹⁴² the fundamental aims of federal securities law will still be fulfilled.¹⁴³ Such are the benefits expected of the new Rules.

B. *Impact of the Proposed Rules on 3(a)(11)*

Whether these benefits could be extended to comparable transactions in 3(a)(11) securities is the central focus of the succeeding discussion. With regard to the requirement of ultimate distribution to resident in-

¹³⁶ Rule 162(a)(4); cf., SEC Rule 154(b), 17 C.F.R. § 230.154(b)(1970). See, *Wheat Report* at 20-21, 191-202, and note 4, *supra*.

¹³⁷ *Wheat Report* at 203-05.

¹³⁸ Rule 180, Sec. Act Release 4997 (1969).

¹³⁹ *Wheat Report* at 174.

¹⁴⁰ See text and sources accompanying notes 30-33, *supra*.

¹⁴¹ *Wheat Report* at 177.

¹⁴² Sec. Act Release 4997 (1969).

¹⁴³ *Id.*; Securities Act, *preamble*, 48 Stat. 74 (1933).

vestors, it can be argued, persuasively it seems, that the new rules could be applied to 3(a)(11), *at least to the extent of regulating subsequent resales outside the state*. In order to fully appreciate the content of this statement, several things must be kept in mind. First the proposed rules, if so applied, would not affect the present requirement that the offering be confined to residents of the state in question. Those in the selling group would still be obliged to insure that each subscriber was a *bona fide* "resident"¹⁴⁴ of the state. Indeed, by the very terms of the statute, this aspect of the current law could hardly be changed. By the same token though, the basic requirements governing the initial placement of unregistered securities under section 4(2), as enunciated in *SEC v. Ralston Purina Co.*,¹⁴⁵ are likewise unaffected by the new rules. The issuer is still constrained to limit his offering to an insubstantial number of "sophisticated" investors whose relationship with the issuer affords them access to financial information.¹⁴⁶ Second, application of the *Wheat Report's* standards to 3(a)(11) would not permit the widespread circulation of unseasoned, unregistered securities immediately after issuance. Here again, the new rules do not allow that under 4(2) either. The holding period, the quantity limitations, and especially the issuer's "qualification" prevent that from happening. In fact, the effect of the change would not be all that noticeable. Rather than allowing the interstate sale of *any* 3(a)(11) security within a few years after the initial offering, as the current rule does, the new standards would actually restrict such sales for as much as five years, in the case of a non-reporting company. Hence they would ". . . operate to inhibit the creation of public markets in securities of issuers which do not disclose information to the public. . . ."¹⁴⁷ Only where the issuer does disclose the required information would the rules permit earlier interstate trading, and then only by a year or two. Thus the change would not involve a radical departure from existing law; and it would conform to projected changes in a comparable area of the law.

The textual aspect of the argument is equally persuasive. By reading the term "distribution" in the same way that it is defined in Rule 162(a), with the word "interstate" being substituted for the word "public" perhaps, then any resale or other transfer to a non-resident, which was consummated at least a year after the initial offering date, would not be deemed a "part of the process of primary distribution."¹⁴⁸ This of course would apply only where the other standards are met; that is, the sale would

¹⁴⁴ Presumably the SEC would adopt Professor Loss's suggestion here, see text and sources at notes 50-54, *supra*.

¹⁴⁵ 346 U.S. 119 (1953).

¹⁴⁶ Op. Gen. Counsel, Securities Act Release No. 285 (Jan. 24, 1935), 17 C.F.R. § 231.285 (1970); *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953); Sec. Act Release 4552 (1962); text and sources at notes 31, 166-70, 173-75.

¹⁴⁷ Sec. Act Release 4997 (1969).

¹⁴⁸ Quoted in text at note 27, *supra*.

also have to be an unsolicited brokerage transaction in limited amounts of a qualified issuer's "restricted" [i.e., 3(a)(11)] securities. In the words of the current phraseology then, the original offering would have "come to rest" in the hands of resident investors "at the time of completion of ultimate distribution,"¹⁴⁹ which would be at the end of one year if the issuer was a reporting company. In the case of a non-reporting company, the "distribution" period would terminate when the issuer qualifies or when the securities cease to be restricted. It should pointedly be emphasized that such a construction would allow the *intentional* resale of 3(a)(11) securities to non-residents. It would do so even though there was no mistake as to the residency of the purchaser. Like 4(2) then, intentional resales under the conditions just described would not be prohibited, nor would the issuer's exemption be lost. In sum, the phraseology fits, or could be adapted to fit, 3(a)(11).

Furthermore the benefits that would accrue to all concerned should be the same by and large. Attorneys would have relatively firm guidelines on which to base their advice. Broker-dealers would have a fairly clear idea, in terms of time, quantities, and methods, as to whether their clients were about to engage in a "distribution" or not. Investors would know with reasonable certainty what the terms of their subscription were. And the Commission, when confronted with suspected violations, would know, or would be able to decide as easily as it now can, whether to act.¹⁵⁰ Further, the public would not be exposed to the temptation of investing in speculative, unseasoned securities any more than it now is under current law. Indeed, it might even be less so. For, as previously stated, the new rules, or a reasonable likeness thereof, would preclude interstate sales of 3(a)(11) securities for as much as five years, unless the issuer becomes a reporting company. As the rule now stands, resales can be made within a few years irrespective of the issuer's status. The key point then is that the time when interstate trading could begin would turn, not so much on the seller's state of mind or other largely meaningless circumstances, but on the "qualification" of the issuer. This is the essence of the new rules. Thus adoption of similar rules for 3(a)(11) would not only provide similar benefits, but it would also result in a much more uniform application of the law.

At this juncture one might wonder as to how many local businesses would ever qualify as reporting companies, even if the rules were applied to 3(a)(11). This would be hard to ascertain with any degree of exactitude, since many issuers using 3(a)(11) would be newly-formed, and so forth. But local counsel estimate that an appreciable number would be affected. This is because more and more local firms now fall within the express

¹⁴⁹ Quoted in text at notes 27 & 17, *supra*.

¹⁵⁰ 1963 *Special Study* at 571-75. See discussion note 81, *supra*.

terms of section 12(g) of the '34 Act;¹⁵¹ therefore they already are, or soon will be, reporting companies. In fact, more than a few intrastate issues have been priced at about \$1,000,000.¹⁵² Should the firm's gross assets exceed that figure and should 500 or more investors subscribe, then even a new issuer would become a reporting company within a year or so after the offering date.¹⁵³ Consequently, application of the *Wheat Report's* standards to 3(a)(11) should not be an idle act.

Finally, and most important, it should be emphasized that all of the conditions and limitations specified in the new rules do not have to be carried over *in toto*. If preferable, the holding period could be lengthened, the quantity restrictions lowered, and so on. The figures need not be the same, only the *certainty* with which the rules are stated.

If this suggestion proves unworkable or unacceptable, then at the very least, the standards could be used as guidelines for determining the issuer's liability when inadvertent casual resales are made. That is, under what is assumed to be the present rule, the issuer faces the threat of absolute liability whenever a single improper transfer occurs. This threat is presumably undiminished by the fact that the seller supposed the purchaser to be domiciled in the state.¹⁵⁴ But if a standard of due care was imposed upon the 3(a)(11) issuer, then the aforementioned standards could serve as a measure of the seller's intent, i.e., whether he had purchased with a "view" to, or had participated in, the "distribution" of the securities.¹⁵⁵ Then any *unintentional* transaction effected in a manner like that described above would not make the seller a statutory "underwriter" and would not destroy the issuer's exemption, provided of course that the procedures outlined in Part II were otherwise followed. This particular application of the standards would not end the inquiry into the seller's state of mind, but at least it would add some objectivity to the search. However, in view of this major defect, the previously asserted suggestion would seem preferable. Although the former is recommended, both possibilities merit consideration.

¹⁵¹ § 12(g) requires that every issuer with "... total assets exceeding \$1,000,000 and a class of equity security (other than an exempted security) held of record by . . ." 500 or more persons, must register his securities within four months after the fiscal year if such securities are traded in interstate commerce or by use of the mails, or if the issuer is "in a business affecting interstate commerce." Securities Exchange Act of 1934, § 12(g)(1), 15 U.S.C.A. § 78l(g)(1)(Supp. 1970). Since many local companies are in a "business affecting interstate commerce," they would be subject to the 12(g) registration requirements as soon as they had 500 shareholders of equity securities and \$1,000,000 in gross assets. In point of fact, the requirements were designed to include practically every publicly-held corporation.

¹⁵² See text and sources at notes 99-100, *supra*. Since most companies would normally borrow on the security of the capital raised in any such offering, they could easily obtain \$1,000,000 in gross assets on an issue priced at considerably below that figure.

¹⁵³ See notes 151-52, *supra*.

¹⁵⁴ See text and sources accompanying notes 23 & 51, *supra*.

¹⁵⁵ See text and sources accompanying notes 19, 27-33, *supra*.

C. *Purposes and Policies of 3(a)(11) and 4(2)*

Assuming that the application of objective standards to 3(a)(11) would be desirable, the remaining question to be pursued is whether the Commission would be justified in doing so. Restated, is there enough similarity in the purposes and policies underlying sections 3(a)(11) and 4(2) to warrant SEC action in this area of the law? Although hardly free from doubt, the contention in favor of the affirmative is not untenable, to say the least. In order to adequately deal with this problem, some mention must be made of legislative purpose.

With respect to 3(a)(11), legislative sources pretty clearly substantiate what the Commission has often said, namely, that the exemption was designed to cover "... only issues which in reality represent local financing by local industries, carried out through local investment."¹⁵⁶ Probably what Congress had in mind here was the typical "... offering by a small businessman of a limited amount of securities to his friends, relatives, business associates, and others."¹⁵⁷ That is, the small, closely-held corporation, the local real estate investment trust, the divider of mineral interests in nearby property, and the like, were to be spared from all of the expense and burdens of federal regulation. "Small local offerings of this character [were] not a matter of Federal concern, [because they could be] adequately supervised by State authority to the extent that regulation [was] deemed necessary."¹⁵⁸ Parenthetically, the alleviation of administrative chores that would otherwise descend upon the SEC was undoubtedly another factor. Without 3(a)(11) the Commission, given its usual budget and manpower levels, could not hope to carry out its statutory mandate and yet still function effectively. The deluge of registration statements would have simply overwhelmed it. This particular facet of 3(a)(11) suggests a point which should be made explicit. The exemption was not predicated on the absence of constitutional power, on the part of the federal government, to reach wholly intrastate offerings. The antifraud and civil liability provisions of the Act¹⁵⁹ clearly show this, i.e., that Congress was aware of its authority to regulate in this area, provided that the requisite jurisdictional nexus was established.¹⁶⁰ Rather 3(a)(11) was enacted primarily for the sake of federalism.¹⁶¹ By this exemption Con-

¹⁵⁶ Sec. Act Release 4434 (1961); Sec. Act Release 1459 (1937); Meeker, *supra* note 65, at 1868. See, H.R. REP. NO. 85, 73d Cong., 1st Sess. (1933); H.R. REP. NO. 152, 73d Cong., 1st Sess. (1933); S. REP. NO. 47, 73d Cong., 1st Sess. (1933); 78 CONG. REC. 10267 (1934) (Remarks of Senators Dirksen & Rayburn). McCauley, *supra* note 10 at 939-41.

¹⁵⁷ 1963 *Special Study* at 570-71.

¹⁵⁸ *Id.*

¹⁵⁹ Securities Act §§ 17 & 12(2), 15 U.S.C.A. §§ 77q & 77l(2)(1963) respectively.

¹⁶⁰ The "jurisdictional" means in the Securities Act is "use of any means or instruments of transportation or communication in interstate commerce or of the mails." *Id.* § 5, 12(2), 17.

¹⁶¹ See Securities Act § 18, 15 U.S.C.A. § 77r (1963); McCauley, *supra*, note 10 at 939-41; 1963 *Special Study* at 570; H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933).

gress sought to maintain state interest and participation in the regulatory business. Thus 3(a)(11) ". . . reflects a congressional policy, expressed in various provisions of the Securities Act, not to preempt the field of securities regulation or to supersede State control, but rather to fill the gap in those areas where State regulation cannot adequately meet a national need."¹⁶² A prime example of how this policy was supposed to work is seen in the common situation where the issuer has incorporated in one state, but has conducted his principal business in another. Since the local securities agency of the state in which an issue could be floated would presumably lack the authority to subpoena records, inspect operating sites, interrogate officers, etc., it would be disabled from investigating the issuer and verifying the information revealed in his registration forms. Thus it would be unable to fulfill its regulatory function.¹⁶³ Here then, federal regulation was to "fill the gap." On the other hand, where the issuer's business was "genuinely local in character,"¹⁶⁴ federal intervention was thought superfluous, if not unnecessary. In other words, the impact of such small issues on national economic affairs was considered to be minimal, or at least not substantial enough to call for federal regulation.

The purposes behind section 4(2) are not quite so clear; in fact, this exemption appears to have been little more than a legislative afterthought.¹⁶⁵ What sources there are though seem to indicate some similarity of purpose. "Sales of stock . . . [were to] become subject to the act unless the stockholders [were] so small in number that the sale to them [would] not constitute a public offering."¹⁶⁶ In such a case, there was ". . . no practical need for . . . the application [of the act] or . . . the public benefits [were] too remote."¹⁶⁷ Statements such as these arguably suggest a congressional purpose not unlike the type previously referred to, i.e., an ". . . offering by a small businessman . . . to his friends, relatives, business associates, and others."¹⁶⁸ In both 4(2) and 3(a)(11), Congress probably intended to exempt only the incorporated partnership, or something slightly larger. More likely than not, Congress never expected that either exemption would be used as extensively as they have been.¹⁶⁹ In a

¹⁶² 1963 *Special Study* at 570.

¹⁶³ *Chapman v. Dunn*, 414 F.2d 153 (6th Cir. 1969).

¹⁶⁴ Sec. Act Release 4434 (1961).

¹⁶⁵ H.R. 5480, 73d Cong., 1st Sess. (1933) originally exempted ". . . transactions by an issuer not with or through an underwriter . . ." The phrase ". . . and not involving any public offering" was appended in the House Committee, H.R. REP. NO. 85, 73d Cong., 1st Sess. 1 (1933). The original phrase in H.R. 5480, *supra*, was then deleted as being superfluous in Securities Exchange Act of 1934, § 203(a), 48 Stat. 906 (1934); see, H.R. REP. NO. 1838, 73d Cong., 2d Sess. 41 (1934). Except for the statement quoted in text at note 166, *infra*, there was no further reference to this exemption.

¹⁶⁶ H.R. REP. NO. 152, 73d Cong., 1st Sess. 25 (1933).

¹⁶⁷ H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933).

¹⁶⁸ 1963 *Special Study* at 570-71.

¹⁶⁹ See quotes and sources at notes 97-100, *supra*.

manner of speaking, both appear to be different sides of the same coin—exemption from federal regulation where the offering was too small to affect the financial health of the nation's economic life. One was limited in terms of geography, the other in terms of the number of offerees, and presumably, their preferred position vis-à-vis the issuer.¹⁷⁰ Thus maybe Congress perceived that some issuers would be unable to avail themselves of 3(a)(11) but would be able to use 4(2), or Regulation A for that matter. The converse of this, of course, is equally plausible. In both cases then, Congress could have assumed that offerings like these could be ". . . adequately supervised by State authorities to the extent that regulation [was] deemed necessary."¹⁷¹ Since neither endangered the public generally, neither was a "matter of Federal concern."

The analogy is by no means complete and there is no intention to imply otherwise. Congress may also have foreseen the growth of institutional investment and the varying uses to which 4(2) would eventually be put. Maybe a dual function for 4(2) was intended. Whether it was or not is unascertainable and perhaps moot. But the mere fact that 4(2) has come to be used for the placement of large issues with a select number of institutional investors does not necessarily negate the earlier suggestion regarding possible legislative intent. It does not, in and of itself, force the contrary conclusion, i.e., that the exemptions are so distinct in purpose and function that comparable treatment is unwarranted. At best, the specific legislative purposes which gave rise to 4(2) are obscure. This being so, there would seem to be no compelling reason, as far as legislative policy is concerned, to preclude the SEC from exercising its rule-making power along the lines suggested above. After all, it was largely the Commission which fashioned the current law. Therefore unless other, more practical reasons can be found, the Commission would appear to have as much authority for acting here as it would with respect to 4(2).¹⁷²

There may, however, be "other, more practical" reasons. For one, although Congress may not have anticipated the uses to which 4(2) would be put, or the magnitude of the offerings made thereunder, certainly the Commission cannot ignore this development. Whether it would make a difference though is problematical. For example, 4(2) was construed in *Ralston Purina* to require that offerees of a private placement be in such a position vis-à-vis the issuer that they are ". . . able to fend for them-

¹⁷⁰ See text and sources accompanying notes 173-75, *infra*.

¹⁷¹ 1963 *Special Study* at 571.

¹⁷² See *Wheat Report* at 153-56 for the Commission's position on its rule-making authority in this area. It is understood, however, that some members of the staff have reservations about the desirability of effecting such a major change in existing law without explicit legislative approval. This is in part due to the feeling that the 12(g) reporting requirements are not working as satisfactorily as was expected. Hence it is possible that the rules may be delayed or even await legislative action.

selves. . . ."¹⁷³ If their relationship with the issuer is such that they are unable to do this, then the issuer is prohibited from making a private offering.¹⁷⁴ Normally though, because they are so situated, they are presumed to have access to the kind of information which would be revealed in a registration statement, i.e., insider's knowledge. As a result, they do not ". . . need the protection of the Act."¹⁷⁵ No such presumption applies to intrastate offerings, however. Further, 3(a)(11) was clearly enacted to promote a legislative interest in federalism. No such policy is discernible in 4(2). Besides, sometimes even the states exempt private offerings to institutional investors.¹⁷⁶ Even so, these differences, standing alone, ought not discourage application of the *Wheat Report's* objective tests to 3(a)(11). For the proposed rules are unabashedly designed to permit the resale of unregistered securities to investors who, not being privy to inside information, are presumptively incapable of fending for themselves. The law now being applied to 3(a)(11) likewise allows such resales after the passage of indeterminate time. Consequently, the presumption of the sophisticated investor is not particularly relevant, nor necessarily fatal to the proposal made herein. Again, the new system is dependent not so much upon the actual knowledge of the investing public, but upon the information which the issuer publicly discloses. If the issuer is a reporting company, then the information should be available to the public by the time that trading begins; if not, interstate trading will be delayed. And in either case, the states' role in the regulatory process will be unaffected. Thus the presumption of the sophisticated investor and the congressional interest in federalism ought not deter the Commission from acting in this area.¹⁷⁷

¹⁷³ SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953).

¹⁷⁴ Op. Gen. Counsel, Securities Act Release No. 285 (Jan. 24, 1935), 17 C.F.R. § 231-285 (1970); Sec. Act Release 4552 (1962); Orrick, *Non-Public Offerings of Corporate Securities—Limitations on the Exemption Under the Federal Securities Act*, 21 U. PITT. L. REV. 1, 10-11(1959); Israels, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851, 859-60 (1959); *Wheat Report* at 160-77; & authorities cited note 31, *supra*.

¹⁷⁵ SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953).

¹⁷⁶ E.g., Ohio Revised Code Ann. § 1707.03(D) (Page 1964).

¹⁷⁷ Possibly one factor, as yet unmentioned, could change the equation—the quality of the securities offered under the different exemptions. The securities ordinarily associated with institutional investment—bonds and preferred stock—are generally thought to offer a more secure investment than those associated with 3(a)(11). Thus the probability of exposing the investing public to high-risk issues might be reduced if only unregistered 4(2) securities are traded. On the other hand, 3(a)(11) offerings would be regulated by state supervisory agencies whereas frequently 4(2) offerings are not. And trading would occur in neither case unless the issuer was a reporting company. Moreover, the association of quality securities with 4(2) offerings is probably somewhat out-dated. In recent times, the pressures to invest in equity or convertible debt securities have been marked enough to undercut the premises upon which this assumption was based. Whether it should be controlling or not is debatable. It should suffice to say, however, that if 3(a)(11) securities are too dissimilar to justify comparable treatment, the reasons therefore are not readily apparent.

IV. CONCLUSION

The primary purpose of this article was to assess the potential impact of the *Wheat Report* proposals on the use of the intrastate exemption. Having done this, it should have become apparent that the objective standards which eventually will be applied to resale transactions in 4(2) securities could be applied to similar transactions in 3(a)(11) securities. And although the specific standards which were designed for trading in 4(2) securities may be unsuitable for the peculiarities of 3(a)(11), the certainty and clarity with which the rules are defined should definitely be the same.

. . . the Study believes that the proposed rules are necessary not only to provide greater predictability, but to give fuller effect to the statutory purpose. . . . (The) most casual inquiry into the effects of [the] prevailing interpretative pattern discloses its grave short-comings in this respect. Sale without registration may turn on events wholly unconnected with the needs of investors, and without distinction as to whether (1) the issuer of the securities is providing information concerning its business and financial affairs in regular reports to the Commission, (2) the quantity of securities being sold without registration is massive or modest, and [whether] (3) there is, or is not, a heavily compensated selling effort involved. The proposed rules have been designed to do away with such anomalies.¹⁷⁸

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¹⁷⁸ *Wheat Report* at 155-56.